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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1948

No. ~~763~~ 63

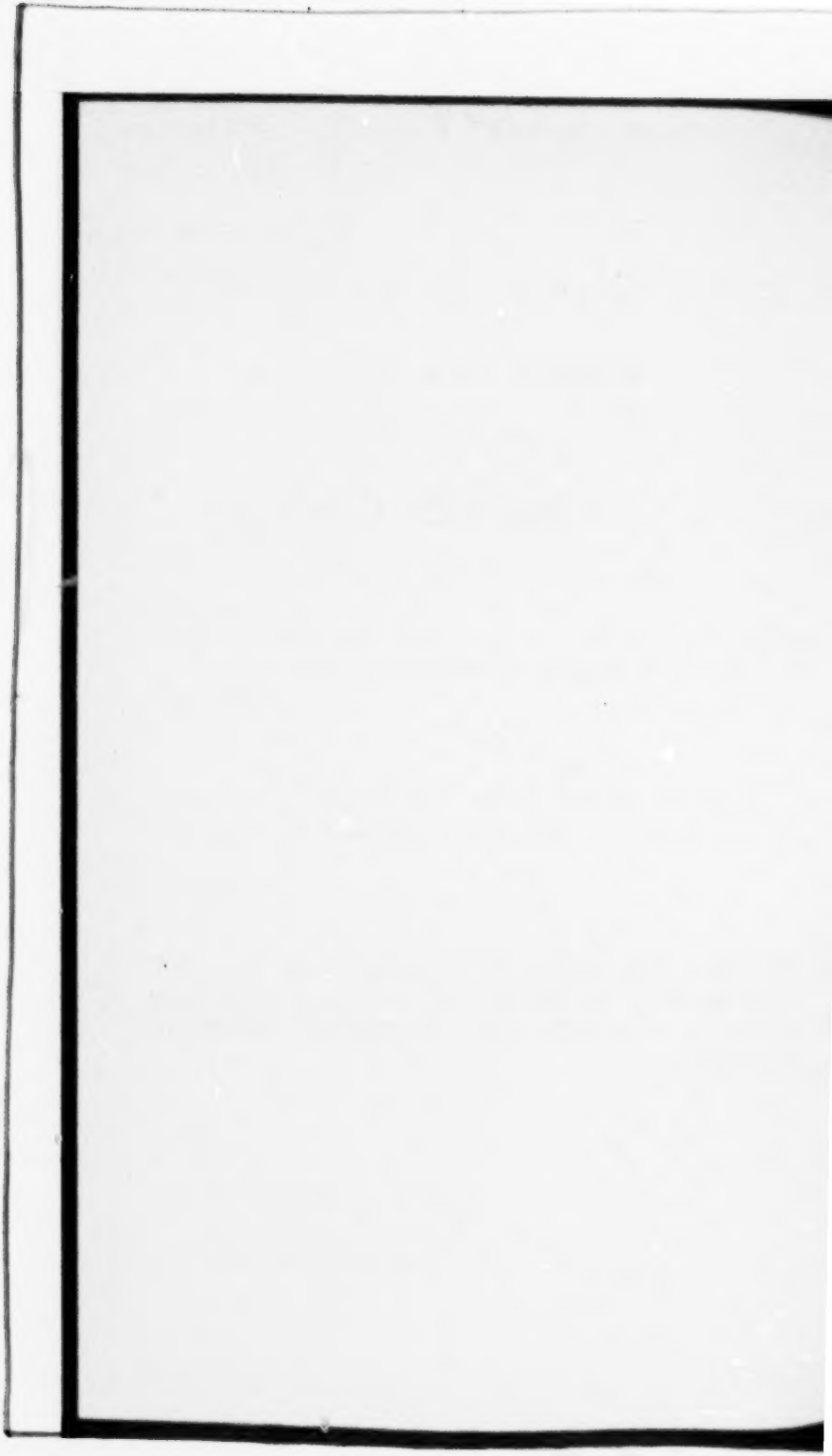
STEELE'S MILLS, A CORPORATION, AND WACHOVIA BANK & TRUST COMPANY, AS TRUSTEE,
Petitioners,

vs.

CHARLES H. ROBERTSON, COLLECTOR OF INTERNAL REVENUE FOR THE COLLECTION DISTRICT OF NORTH CAROLINA

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

JOHN M. ROBINSON,
RUSSELL M. ROBINSON,
HUNTER M. JONES,
Counsel for Petitioners.



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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1948

No. 763

STEELE'S MILLS, A CORPORATION, AND WACHOVIA BANK & TRUST COMPANY, A CORPORATION, AS TRUSTEES,

Petitioners,

vs.

CHARLES H. ROBERTSON, COLLECTOR OF INTERNAL REVENUE FOR THE COLLECTION DISTRICT OF NORTH CAROLINA,

Respondent

PETITION FOR WRIT OF CERTIORARI

TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioners pray that a writ of certiorari issue to review the decree of the United States Court of Appeals for the Fourth Circuit entered February 11th, 1949, reversing the decree of the United States District Court for the Middle District of North Carolina. A certified transcript

of the record in the case, including the proceedings in said Court of Appeals, is furnished herewith in compliance with Rule 38 of this Court.

Summary and Short Statement of the Matter Involved

This case involves the deductibility, for income tax purposes, under Section 23(a) of the Internal Revenue Code, of a payment to an employees' trust to be administered by a committee of employees for the benefit of those employees of taxpayer who are faced with emergencies resulting from sickness or accident.

On December 30, 1941, Steele's Mills, a textile manufacturer, established a trust for the benefit of its employees. The trust instrument (R. 1-9) recited that the grantor had enjoyed the loyal and satisfactory support of its employees for many years and desired to further and strengthen the same by establishing a foundation to be called the "Steele's Mills Foundation" to which there should be transferred properties and funds to be used for the benefit of said employees and their dependents in case of illness or emergencies.

The instrument provided for benefits to employees and their dependents in case of emergencies caused by illness or accident. The benefits were to be granted upon approval by a committee of employees named in the instrument. The Court of Appeals mentions benefits originating as loans which might later be converted into gifts. It is apparent from the reading of the instrument as a whole that outright original grants are also authorized.[1] There are restrictions as to individual and aggregate loans. Employees eligible

[1] Indeed it was so held in the declaratory judgment action in the Superior Court of North Carolina and upheld, in that respect by the Supreme Court of North Carolina. *Wachovia Bank & Trust Co.* v. *Steele's Mills*, 225 N. C. 302, 34 S. E. (2nd) 425.

for benefits consist of those who have one year of continuous employment. On termination of the trust the remaining funds are to be distributed to those employees who then have five years continuous employment, in proportions determined by the committee of employees on the basis of earnings and services.

On December 30, 1941, Steele's Mills paid into the trust cash and bonds of the aggregate value of $28,610.00, which it claimed as a tax deduction under Section 23(a) of the Internal Revenue Code. The deduction was disallowed, resulting in a deficiency tax assessment of $22,257.27, which was paid under protest. The petitioner's claim for refund was filed and disallowed and this suit was brought in the District Court to recover the tax so assessed and paid. The District Court, sitting without a jury, made findings of fact favorable to the petitioner (R. 20-24) including a finding that the payment in question was an ordinary and necessary expense of carrying on the petitioner's business, and rendered judgment in its favor. The findings of fact of the District Court were based on the trust instrument plus oral evidence as to the policy of the taxpayer in previous years, the conditions peculiar to the textile industry and the circumstances resulting in the establishment of the Trust in question. (R. 44-58) On appeal to the Court of Appeals for the Fourth Circuit, the judgment of the District Court was reversed on the ground that the payment was in the nature of a capital expenditure rather than an ordinary and necessary expense. The opinion pays scant attention to the District Court's findings of fact and apparently assumes that no issue of fact was involved. The opinion of the Court recognizes that its decision conflicts with that of the Circuit Court of Appeals for the Sixth Circuit in *Lincoln Electric Company* v. *Commissioner*, 162 F. (2nd) 379 (R. 60-69).

It was proven and found as a fact that the past policy of Steele's Mills with reference to its employees had already resulted in the attainment of good labor relations (R. 21) and that the purpose of the expenditure here involved was to continue that policy (R. 22). The Court of Appeals, impressed with the fact that the trust was so set up that, under normal conditions, it would continue to function for 20 years, concluded that the grantor would gain economic advantage over that period. Without further analysis of what capital asset taxpayer acquired, the Court of Appeals declared the expenditure a capital one as a matter of law. The Court left out of consideration the fact proven and found by the District Court (R. 23), that to attain this normal functioning other contributions were necessary. One was made in 1942 (R. 17). Then came the tax litigation. The Court of Appeals treats a *fund* belonging to the employees and designed to benefit them over a period of 20 years as a capital asset of the employer having an economic life of 20 years.

Question Presented

The question presented is whether the Court of Appeals for the Fourth Circuit erred in holding as a matter of law that the payment to the Trust Fund in 1941 was a capital expenditure and not an ordinary and necessary expense; and in rejecting the District Court's finding of fact that it was an ordinary and necessary expense.

Basis upon Which the Court Has Jurisdiction to Review the Judgment and Decree Below

Jurisdiction is invoked under Title 28 U. S. Code, Section 1254.

Federal Statute Involved

Internal Revenue Code:

"Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or Business Expenses—

(A) In general—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

Reasons Relied On for Allowance of the Writ

The reasons relied on for allowance of the writ are:

(a) The decision of the Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Lincoln Electric Co. vs. Commissioner, 162 F. (2nd) 379,* upon the ultimate question of allowance of the tax deduction here claimed under Section 23(a) of the Internal Revenue Code.

(b) The Court of Appeals below has decided an important question of federal law which has not been, but should be, settled by the Supreme Court, to-wit: whether an expenditure (in the way of a payment into an employees Trust to provide sickness and accident benefits) made by an employer to preserve and maintain favorable existing labor relations, as distinguished from a like expenditure to acquire such relations, may be found to constitute an ordinary and necessary expense of doing business within the meaning of Section 23(a) of the Internal Revenue Code.

(c) The Court of Appeals has decided a federal question in a way probably in conflict with applicable decisions of the Supreme Court, in that it treats the question of what is an ordinary expense as one of law

whereas under applicable decisions of the Supreme Court what is an ordinary expense is usually a question of fact.

WHEREFORE your petitioners respectfully pray that a writ of certiorari be issued to the United States Court of Appeals for the Fourth Circuit to the end that this cause may be reviewed and determined by this court; that the decree of the Court of Appeals for the Fourth Circuit be vacated and set aside; and that your petitioners be granted such other and further relief as may be proper.

STEELE'S MILLS, a corporation, and
WACHOVIA BANK & TRUST COMPANY,
a corporation, as Trustee,
Petitioners.

JOHN M. ROBINSON,
RUSSELL M. ROBINSON,
HUNTER M. JONES,
Counsel for Petitioners.

BRIEF FOR PETITIONERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

The Opinions of the Court Below

The opinion of the District Court is unreported but appears in the record (R 25).

The opinion of the Court of Appeals for the Fourth Circuit is reported as follows:

Robertson v. *Steele's Mills, et al.*, 172 F. (2nd) 817.

Jurisdiction

Jurisdiction is invoked under Title 28, United States Code, Section 1254.

Statement of the Case

Recovery of a deficiency assessment of income and excess profits tax, paid under protest for the tax year 1941, was sought in the District Court on the ground that the tax resulted from erroneous disallowance of a deduction claimed as an ordinary and necessary expense of carrying on the business of Steele's Mills during the tax year. The expenditure in question consisted of a transfer of bonds and payment of cash into a Trust Fund to be administered by a committee of employees to aid employees of Steele's Mills and their dependents in emergencies caused by sickness or accident. The trust was designed to last for 20 years but could be sooner terminated by the grantor. It was contemplated that additional payments into the fund would be made during the life of the trust.

Jury trial was waived and the District Court found the facts, (R. 20-24), made conclusions of law (R. 24) and rendered judgment for the plaintiff. (R. 25).

In the Court of Appeals the Commissoner, in his brief, expressly accepted the findings of fact of the District Court "with the exception of the ultimate conclusion (R. 23, 24)

that the expenditure here involved qualified for deduction under Section 23(a) of the Internal Revenue Code."

Consequently we set out as an adequate statement of the facts before the Courts below the first 15 findings of the District Court of which only the 14th seems to be questioned by the respondent:

1. That Steele's Mills is a corporation duly organized in the year 1895 under an act of the Legislature of North Carolina.

2. Upon its organization, the corporation embarked in the business of the manufacture of cotton textile products. Its plant was erected about six miles from Rockingham, N. C. in a comparatively remote section, and it was necessary for the corporation to erect dwelling houses for its employees and their families. This created a little village or community of its own somewhat removed from other mills and industries.

3. That the corporation eventually employed about 500 operatives and they, together with their families, constituted a village of about 1500 people. Children and grandchildren of the original employees had a tendency to stay on in the village where they were born and reared.

4. For many years prior to World War I, the corporation had a hard struggle to continue operating due largely to changes in the market for goods which it was equipped to manufacture. The cotton textile industry is one of a hazardous and fluctuating nature, and the industry is peculiarly subject to periods of depression. The scale of wages paid in the textile industry is comparatively low. The employees are not able to create reserves to take care of emergencies. They are peculiarly subject to emergencies arising from accident and disease. In case of disease or accident affecting the dependent of an employee, the expense involved almost always results in some financial stress, and in cases where an employed member of the family

is required to miss work to take care of the sick or injured person, the loss of income resulting therefrom increases the burden. In those cases where an employee himself is either sick or injured, there is always expense and loss of income to be dealt with.

5. For years prior to December 30, 1941, it had been the policy of the corporation to aid its employees in cases of emergencies. Prior to the adoption of the National Labor Relations Act, the company was able to extend much assistance of a general nature to its employees by the extension of credit in a general store owned by a subsidiary. This credit was available to all employees, and the accounts were collected through payroll deduction. This credit was not only extended for purchases made from its store, but to cover medical and hospital expenses, insurance and any other needs which the employee had. In this way the employees could obtain a credit for getting the necessities of life when any emergencies arose. There were some losses, but most of the accounts were ultimately paid.

6. That this policy was a beneficial one to the corporation inasmuch as it built up the morale, good will and loyalty of its employees, and created a favorable labor situation for the corporation.

7. After the adoption of the National Labor Relations Act, the policy above outlined was rendered impractical because the company was no longer allowed to collect accounts of its employees through payroll deductions.

8. That on December 30, 1941, the corporation established a trust known as Steele's Mills Foundation by the execution of the trust agreement, a copy of which is set forth in Exhibit 5 attached to the complaint, being Exhibit A therein set forth.

9. That the trust agreement referred to in the preceding finding was duly executed by all the parties thereto, and its execution by Steele's Mills was duly approved by the Board of Directors of said corporation.

10. That the object of establishing said Foundation was to make reasonable and adequate provision for continuing and perpetuating the policy which the corporation had pursued for many years prior thereto, providing means for caring for the individual needs of the employees in case of emergency from accident or disease. In establishing the Foundation, the corporation determined that it would be the part of business wisdom in prosperous times to establish a permanent trust so as to stabilize and secure the policy which the corporation had theretofore pursued.

11. On December 30, 1941, cash and bonds aggregating the sum of twenty-eight thousand, six hundred and ten ($28,610) dollars were turned over by the corporation to the trustee of said Foundation.

12. That during the year 1941 the salaries and wages paid to eligible employees totalled about $437,000. Hence the payment to the Fund during that year was slightly in excess of 6% of the labor costs, and upon the basis of 1500 people in the mill village, the payment represented about nineteen dollars per person for the year.

13. That the payments made to the Foundation in 1941 were about 5% ofthe net profits of said year before income taxes.

14. These payments by the corporation to Steele's Mills Foundation constituted a part of the ordinary and necessary expense of operating the business of the corporation; and constituted proper and necessary corporate disbursements for said purpose.

15. That, under the circumstances herein set forth, the payment to the Foundation during the year 1941 was reasonably necessary to carry out the objects of said Foundation; and that for said trust to function properly it would have been necessary to pay in additional funds as was then contemplated to be done in subsequent years.

The Trust instrument referred to in finding 8 above is set out in full in the record (R. 1-9) and its terms are analyzed in the petition filed herewith.

The Court of Appeals recognizes that there is no dispute as to the basic facts (R. 60) but apparently does not consider the finding that the expense was ordinary and necessary as properly a finding of fact, since there would seem to be no question that it (the finding) is basic.

The Court of Appeals recognizes that its decision conflicts with that of the Sixth Circuit in *Lincoln Electric Company* v. *Commissioner*, 162 F. (2nd) 379.

The Court of Appeals accepted as applicable and as containing correct reasoning the decision of the Tax Court in *Roberts Filter Manufacturing Co.* v. *Commissioner*, 10 T. C. 26, later affirmed by the Court of Appeals for the Third Circuit by opinion filed March 25, 1949, and not yet reported.

It will be noted that the opinion of the Court of Appeals for the Third Circuit in the *Roberts Filter* case, *supra*, does not recognize as conflicting, but undertakes to distinguish, the *Lincoln Electric Company* case, *supra*.

Both the Circuit Court of Appeals for the Sixth Circuit in the *Lincoln Electric* case and the court below in this case treated the question of an ordinary and necessary expense as one of law—overturning in each case the finding of fact of the trial court on that question. On the other hand the Court of Appeals for the Third Circuit in the *Roberts Filter* case apparently recognizes the question as one involving a finding of fact because the concluding paragraph of the opinion in that case contains these words:

> ". . . there was substantial basis for the Tax Court decision that the creation of this trust was not an ordinary and necessary expense of petitioner."

Thus there is conflict of opinion among the Courts of Appeal as to what *may* be found to be an ordinary and neces-

sary expenditure with respect to payments into trust funds of the nature here involved. There is also conflict or confusion as to when the decision of this question involves a question of ultimate fact upon which the finding of the trial court should be accepted if it has substantial support in the evidence.

Specification of Errors

The error which the petitioners will urge if the writ is granted is that the Court of Appeals for the Fourth Circuit erred in holding that the payment in question was a capital expenditure instead of an ordinary and necessary expense for the year in question and in failing to accept the District Court's finding of fact that it was an ordinary and necessary expense.

Summary of Argument

I

THERE IS A CONFLICT BETWEEN THE HOLDING OF THE COURT OF APPEALS BELOW AND THE CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

II

THE DECISION BELOW DECIDES AN IMPORTANT QUESTION OF FEDERAL LAW WHICH HAS NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT.

III

THE DECISION BELOW DECIDES A QUESTION OF FEDERAL PROCEDURE IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

ARGUMENT

I

There is a conflict between the holding of the Court of Appeals below and the Circuit Court of Appeals for the Sixth Circuit.

After referring to *Lincoln Electric Co.* v. *Commissioner*, 162 F. (2nd) 379 (C. C. A. 6th) and *Roberts Filter Manu-*

facturing Co. v. *Commissioner,* 10 T. C. 26, the Court below said:

> "Though the facts in the three cases are not identical we think these cases are so similar that the same result should be reached in the instant case, in the Roberts Filter case and the Lincoln Electric Case. . . . We prefer the reasoning in the Roberts Filter case. . . . We, therefore, think the judgment of the District Court in the instant case must be reversed."

Thus the court below recognizes a direct conflict in its decision and that of the Sixth Circuit. Each court ruled squarely, as a matter of law, disregarding the finding of fact of the trial court in each case, on the ultimate question of ordinary and necessary expense.

The Lincoln Electric Company decision holds that a $1,000,000 payment into a trust fund for employees of Lincoln Electric Company to be paid out to them in emergencies caused by termination of employment over a period of years is an ordinary and necessary expense and not a capital expenditure where the purpose was to maintain existing good labor relations. The decision below holds that a payment of $28,610.00 into a trust fund for employees of Steele's Mills to be paid out to them in emergencies caused by sickness or accident over a period of years is a capital expenditure and not an ordinary and necessary expense where the purpose, likewise, was to maintain existing good labor relations.

II

The decision below decides an important question of Federal law which has not been, but should be, settled by this Court.

Both the Circuit Court of Appeals for the Sixth Circuit in the *Lincoln Electric* case and the Court below in this case relied on the reasoning in the case of *Welch* v. *Helvering,*

290 U. S. 111. But neither apparently considers it controlling on the facts because the expenditure there was to acquire good will rather than maintain existing good will.

No other decision of the Supreme Court is cited as deciding the ultimate question. In this situation, it is apparent that a question is now presented which has not heretofore been decided by this Court to-wit: whether the payment of funds into an employee trust to be used for the benefit of the employees over a period of years may be found as a fact to be an ordinary and necessary expense where the purpose is to maintain existing good labor relations rather than to acquire such relations.

There is no argument between the Circuits as to whether the expenditure is necessary. The argument is whether it is ordinary so as to be treated as a current expense of the year's business or whether extraordinary and made to acquire an asset with an extended useful life so as to be a capital expenditure.

That this already has become an important question of federal law is demonstrated by the fact that the Courts of Appeal in three Circuits have almost concurrently been called upon to decide the question. That it will become increasingly important is a corollary of the increasing and well known prevalence of employee trusts and other employee benefits in an industrial system which more than ever before has come to realize not only the importance but the absolute necessity of maintaining favorable labor relations.

The Court of Appeals in effect treats the trust fund as if it was still an asset of the taxpayer and was to be disbursed by it in future years, thereby obtaining a new benefit with each expenditure. This is clearly contrary to the facts. The fund belongs to the employees subject, of course, to the limitations upon its enjoyment specified in the instrument.

If the taxpayer had given all its employees a bonus of 6% of their wages in a good year to preserve good will, doubtless it would not have been questioned as a proper deduction. When, instead, taxpayer uses the same amount of money to create a fund which will aid employees who may face an emergency it is said that it becomes a capital expenditure. The fund has passed just as effectively out of the ownership of the taxpayer to the employees in one case as in the other. So far as the *fund* is an asset it belongs to the employees. The Court of Appeals does not tell us what capital asset Steele's Mills acquired. Yet its own prior decisions recognize that a necessary corollary to a capital expenditure is the acquisition of a capital asset.

Gauley Mountain Coal Co. v. *Commissioner,* (C. C. A. 4th) 23 F. (2nd) 574, 576.

It is submitted that an expenditure to maintain existing good will or employee loyalty should be entitled to the same treatment as an expenditure to maintain buildings and equipment. If a substantial item of machinery is bought the cost is a capital expenditure. Likewise, if good will of employees is *acquired,* the cost is a capital expenditure. If a machine is oiled and cleaned, the cost is an ordinary and necessary expense, and not a capital expenditure. Likewise, we contend, if a reasonable expenditure is made to maintain and preserve existing good employee relations (as found in this case by the trial court and accepted by the Court of Appeals as indicated by the quotation below) it should be held an ordinary expense and not a capital expenditure.

The essence of the error of the Court of Appeals, as petitioners contend, lies in the following sentence in the opinion below (R. 68):

> "We think the result would be the same whether (1) taxpayer made this expenditure when it first started

> business to acquire this intangible asset, or (2) taxpayer, as here, made this same expenditure to preserve and maintain admirable existing labor relations."

On this point the Court of Appeals below is in conflict both with the Circuit Court of Appeals for the Sixth Circuit in the *Lincoln Electric* case, *supra*, and with the Circuit Court of Appeals for the Second Circuit, in *Dunn & McCarthy, Inc.* v. *Commissioner*, 139 F. (2nd) 242. In the case just cited the Court, distinguishing the *Welch* case, said (P. 244):

> "Welch made a capital outlay to acquire good will for a new business. In the present case the payment was an outlay to retain an existing good will, . . ."

III

The decision below decides a question of Federal procedure in a way probably in conflict with applicable decisions of this Court.

What is an ordinary and necessary expense within the meaning of the tax law is ordinarily a question of fact.

Old Mission Portland Cement Co. v. *Helvering*, 293 U. S. 289;

Commissioner v. *Heininger*, 320 U. S. 467.

It is a variable affected by time and place and circumstance.

Welch v. *Helvering*, 290 U. S. 111.

The Court below treats it as a question of law, overruling the decision of the District Court based on a finding of fact that the expenditure was ordinary and necessary. In so doing, we submit that the Court below erred and ruled contrary to applicable decisions of this Court.

Conclusion

In the premises, it is earnestly urged that the petition be granted.

Respectfully submitted,

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Counsel for Petitioners.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No. 63

STEELE'S MILLS, A CORPORATION, AND WACHOVIA BANK & TRUST COMPANY, AS TRUSTEE,

Petitioners,

vs.

CHARLES H. ROBERTSON, COLLECTOR OF INTERNAL REVENUE FOR THE COLLECTION DISTRICT OF NORTH CAROLINA

PETITIONERS' REPLY BRIEF TO RESPONDENT'S BRIEF OPPOSING THE GRANTING OF THE WRIT OF CERTIORARI.

I

Conflict Not Removed by Second Opinion in Lincoln Electric Company Case

The brief of the respondent treats the latest decision of the Court of Appeals for the Sixth Circuit in *Commissioner* v. *Lincoln Electric Company,* decided August 29th, 1949, C. C. H. Par. 9388, as receding from the decision of the same court on the prior appeal in that case to the effect that the payment to the employees benefit fund was, in nature and character, an ordinary and necessary expense within the meaning of Section 23(a) of the Internal Revenue Code. A reading of the opinion completely refutes this argument.

The Court expressly adhered to its prior opinion to the effect that the expenditure was, in nature and character, an ordinary and necessary expense. The Court further held, however, that an additional factual question, not theretofore decided in that case by the tax court, was presented, to-wit: the reasonableness of the amount of the expenditure. While the soundness of that conclusion may be questioned, it is pointed out that, in the instant case, the additional question of fact has, in effect, already been passed upon by the District Court, the fact finding tribunal in this case. See Finding of Fact No. 15, Record page 23.

The decision of the Court of Appeals for the Sixth Circuit in the Lincoln Electric Company case on both appeals is squarely to the effect that the expenditure in question is, in nature and character, an ordinary and necessary expense within the meaning of Section 23(a). The decision of the Court of Appeals for the Fourth Circuit in this case is squarely to the effect that a like expenditure is not, in nature and character, an ordinary and necessary expense within the meaning of Section 23(a) of the Internal Revenue Code. Thus there is a clear-cut conflict between the decision of the two courts as is recognized by the Court of Appeals for the Fourth Circuit in this case, *Robertson, Collector,* v. *Steele's Mills, et al.,* 172 F. (2) 817, with respect to the first Lincoln Electric decision, *Lincoln Electric Company* v. *Commissioner,* 162 F. (2) 379.

II

Application of Section 23(p)

On page 13 of Respondent's Brief is an argument to the effect that the 1942 amendments to Section 23(p) and related sections, preclude the application of Section 23(a) to payments of the nature here involved for tax years subsequent to 1941. This is by no means certain. It would depend on whether the payments were under a "stock bonus,

pension, profit-sharing, or annuity plan," or were deferred compensation. If they fall in none of these categories, Sec. 23(p) as amended in 1942 would not be applicable. This is a question of construction which may well arise but does not arise in this case because the year involved here is 1941. It is of interest that the case of *Roberts Filter Manufacturing Company* v. *Commissioner*, 174 F. (2) 79 (C. A. 3rd) also involved the tax year 1941. The Respondent's argument that it is the 1942 amendment which precludes the application of Sec. 23(a) to cases of this kind and Respondent's failure to place any reliance on Sec. 23(p), up to this time, in this case seem to indicate that the Respondent is not in agreement with reliance on Sec. 23(p) in the *Roberts Filter* case involving 1941.

It is submitted that this case, the *Lincoln Electric* case, and the *Roberts Filter* case show a conflict between the Courts of Appeal the importance of which is not minimized by the 1942 amendments to the Internal Revenue Code, but that those amendments merely present an additional question of statutory construction.

Conclusion

Petitioners' position with respect to Respondent's remaining arguments is sufficiently indicated in the Petition and Brief filed therewith. Based thereon, Petitioners earnestly solicit the granting of the Writ of Certiorari.

Respectfully submitted,

JOHN M. ROBINSON,
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Counsel for Petitioners.

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4 Mertens, *Law of Federal Income Taxation*, Secs. 25.17–25.32	8
H. Rep. No. 2333, 77th Cong., 2d Sess., p. 51 (1942–2 Cum. Bull. 372, 413)	13
Treasury Regulations 103, Sec. 19.21–1	7, 16
Treasury Regulations 111, Sec. 29.23 (p)–1	14

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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 63

STEELE'S MILLS, A CORPORATION, AND WACHOVIA BANK & TRUST COMPANY, AS TRUSTEE, PETITIONERS

v.

CHARLES H. ROBERTSON, COLLECTOR OF INTERNAL REVENUE FOR THE COLLECTION DISTRICT OF NORTH CAROLINA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 25) is not reported. The opinion of the Court of Appeals (R. 60–69) is reported at 172 F. 2d 817.

JURISDICTION

The judgment of the Court of Appeals was entered February 11, 1949. (R. 69.) The petition for a writ of certiorari was filed May 4, 1949.

The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.[1]

QUESTION PRESENTED

Whether a trust fund created by taxpayer-employer in the taxable year 1941, distributable in future years in consideration of future services of its employees, represented a current operating expense of taxpayer's business deductible from its 1941 gross income under Section 23 (a) (1) (A) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 15–17.

STATEMENT

The facts found by the District Court (R. 20–24) may be summarized as follows:

The taxpayer corporation, a manufacturer of cotton textile products, maintains its plant in a remote North Carolina village whose 1,500 population consists of taxpayer's 500 employees and their families. (R. 20.) The scale of wages in the industry is comparatively low, and for many years prior to the taxable year (1941) it had been taxpayer's policy to aid its employees in financial

[1] By orders of this Court dated May 31, 1949, and July 19, 1949, the time for filing a response to the petition was extended to thirty days after the entry of judgment by the United States Court of Appeals for the Sixth Circuit in a second appeal pending in the case of *Lincoln Electric Co.* v. *Commissioner*. The second appeal in that case was decided August 29, 1949.

emergencies by extending credit at the company store and for medical and hospital expenses, a policy which built employee good will and reduced labor turnover. The credits thus extended to the employees were collected through payroll deductions. After adoption of the National Labor Relations Act, which prevented collection of employee accounts through payroll deductions, this practice was discontinued. (R. 20–21.)

On December 30, 1941, taxpayer executed a trust agreement and on the same day turned over to the trustee bank $28,610 in cash and bonds. (R. 22.) The trust agreement (R. 1–9), which is incorporated by reference in the District Court's findings (R. 22), stated that its purpose was the "furtherance and strengthening of the loyalty and good will" of taxpayer's employees (R. 2). It provided that the trust fund was to be used in the discretion of a committee to make loans (not exceeding $100) at 6% interest to employees who needed financial assistance in case of illness or accident and who had been in taxpayer's employ at least one year preceding their request for benefits, or to their dependents; the committee in its discretion could convert any loan into a "donation." (R. 4–5.) Any employee who left taxpayer's employ was to "forfeit" all benefits in the fund. (R. 4.) Collections of loans were to be made through taxpayer's payroll. (R. 5–6.) Expenditures of the trust fund were not to exceed

in any one year the trust income for that year plus 5% of the original principal, except with taxpayer's written approval; at no time were loans to employees to exceed 20% of the original principal; and no expenditure (except for administration expenses) could be made within one year of the creation of the trust, except in an emergency declared by the committee. (R. 6.) The trust was to continue for twenty years, and taxpayer could terminate it sooner by notice to the trustee or extend the term by amendment. At the termination of the trust the fund then on hand was to be distributed to such of taxpayer's employees who "shall have had at least five years continuous service with the Grantor [taxpayer] immediately preceding the termination of the trust," and whom the committee considered most deserving on the basis of services and prior wages. (R. 8.) Taxpayer reserved the right at any time to amend the trust instrument, except to revert in itself any of the trust fund (R. 8–9), and the right at any time upon written notice to remove the trustee, or any member of the committee, and to appoint successors (R. 7, 8). It also reserved the privilege, but did not obligate itself, to increase the trust fund. (R. 2.)

The wages paid by taxpayer in 1941 totaled about $437,000, or an average of about $875 for each of its 500 employees. The trust fund represented slightly more than 6% of taxpayer's total

labor cost for the year, and about 5% of its net profits before income taxes. (R. 22.)

In its 1941 tax return taxpayer deducted the entire amount of the trust fund from its gross income for that year. (R. 23.) After the Commissioner disallowed the deduction, the trust agreement was amended by an instrument executed December 10, 1943 (R. 10–15), which is incorporated by reference in the District Court's findings (R. 23). This amendment provided that the trust was to defray any taxes due from taxpayer by reason of the Commissioner's disallowance of the claimed deduction, as well as the costs incurred by taxpayer in seeking recovery of the taxes paid. (R. 12, 13.) In 1944 taxpayer paid the deficiency ($22,257) by check of the trustee payable to it and endorsed to the Collector. (R. 23.) Thereafter it duly filed a claim for refund, which was denied, and instituted suit for refund in the District Court below. (R. 24.) Proceedings were subsequently instituted by taxpayer in the North Carolina Superior Court for a declaratory judgment as to the validity and construction of the trust; that court declared the trust valid and interpreted its provisions broadly, and its decree was affirmed by the North Carolina Supreme Court with certain modifications. (R. 24, 40–43.)

In addition to the above findings, the uncontradicted testimony of taxpayer's president shows that (1) the trust has never functioned in any

way, and up to the date of the trial "no employee has obtained any benefits whatever from it" (R. 17, 19–20); (2) taxpayer's purpose in creating the trust was to "provide in prosperous years for lean years" (R. 18–19); and (3) the suit for a declaratory judgment brought in the North Carolina court was not an adversary proceeding, but a "friendly" suit in which all the parties were "trying to get the same result" (R. 17, 19).

The District Court held that the trust fund was deductible from taxpayer's 1941 gross income under Section 23 (a) of the Internal Revenue Code as an ordinary and necessary expense of carrying on taxpayer's business in that year (R. 24), and granted judgment for taxpayer (R. 25–26). It did so on the theory that the disposition of this case was "controlled" as a matter of law by *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C. A. 6th), rather than by *Roberts Filter Mfg. Co.* v. *Commissioner,* 10 T. C. 26, then pending on petition for review in the Court of Appeals for the Third Circuit. (R. 25.)[2] The Court of Appeals reversed, holding that the expenditure creating the trust fund was not a current operating expense of taxpayer's business falling within the purview of Section 23 (a), but was a capital outlay designed to benefit the business over a number of future years. (R. 60–69.)

[2] The Tax Court's decision in the *Roberts Filter* case was subsequently affirmed, 174 F. 2d 79.

ARGUMENT

There is no occasion for further review. The decision below is correct and does not present a conflict.

1. The only business expenses allowable as deductions under Code Section 23 (a) (Appendix, *infra*), for purposes of computing the net income for a given taxable year, are the ordinary and necessary expenses paid or incurred in carrying on the business during that year. Expenditures which yield economic benefits to the business over a number of years are non-deductible capital investments, not current operating expenses chargeable against the gross income of a single taxable year. This rule applies to expenditures which yield intangible benefits, as well as to those made to acquire tangible property.[3] Section 24 (a) (2) of the Internal Revenue Code (Appendix, *infra*); Section 19.21–1 (c) of Treasury Regulations 103 under the Code (Appendix, *infra*); *Welch* v. *Helvering,* 290 U. S. 111; *Houston Natural Gas Corp.* v. *Commissioner,* 90 F. 2d 814 (C. A. 4th), certiorari denied, 302 U. S. 722; *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (C. A. 3d); *Commissioner* v. *Boylston Market Ass'n.,* 131 F. 2d 966 (C. A. 1st); *Acer Realty Co.* v. *Commissioner,* 132 F. 2d 512 (C. A. 8th); *Baton Coal Co.* v. *Com-*

[3] The only deductions allowable on account of capital expenditures are for depreciation or depletion of business assets having a limited useful life. Code Section 23 (l) and (m).

missioner, 51 F. 2d 469 (C. A. 3d), certiorari denied, 284 U. S. 674; *Sunray Oil Co.* v. *Commissioner,* 147 F. 2d 962 (C. A. 10th); *Becker* v. *Evens & Howard Sewer Pipe Co.,* 70 F. 2d 596 (C. A. 8th); 4 Mertens, *Law of Federal Income Taxation,* Secs. 25.17–25.32.

The employees' trust fund which taxpayer here seeks to deduct from its 1941 gross income unquestionably represented an expenditure designed to benefit its business over a number of future years, not an expense of that year. The trust was to continue for twenty years, and by amendment taxpayer could extend its term indefinitely. (R. 8.) The fund was to be used in the discretion of a committee to make loans to employees who had been in taxpayer's employ at least one year preceding their request therefor, and the committee could convert any loan into a "donation." (R. 4–5.) Expenditures from the fund were not to exceed in any one year the trust income for that year plus 5% of the corpus, except with taxpayer's approval; and no part of the fund could be disbursed to any employee during the first year except in an emergency. (R. 6.) Any employee who left taxpayer's employ was to "forfeit" all benefits. (R. 4.) Upon termination of the trust, the fund on hand was to be distributed only among such of the employees who "shall have had at least five years continuous service with the Grantor immediately preceding the termination of the trust." (R. 8.) Significantly, up to the time of

the trial (1948) no part of the fund had yet been credited or disbursed to any employee. (R. 17, 19–20.) In substance the trust fund represented nothing more than a reserve set aside by taxpayer to pay additional compensation for services to be rendered by its employees in *future* years. Indeed, the avowed purpose of the trust was to strengthen the "loyalty and good will" of the employees (R. 2), and thereby induce them to remain in taxpayer's employ. Whether the fund be viewed as additional compensation or as some other class of business expense, it patently was not an expense of the taxable year falling within the purview of Section 23 (a). It was to be used to defray anticipated expenses of carrying on the business in later years. ***Roberts Filter Mfg. Co.*** v. ***Commissioner,*** 174 F. 2d 79 (C. A. 3d).[4]

It is fundamental that our federal system of taxation is based on an annual accounting of profits and losses. To permit a taxpayer to offset against its business income for a single taxable year an expenditure intended to benefit the business over a number of future years would violate

[4] As pointed out in the *Roberts Filter* case, *supra*, involving a similar issue, it is clear from the legislative history of Code Section 23 (p) (Appendix, *infra*), covering the deductibility of contributions to pension trusts, that Congress intended in Section 23 (a) to authorize the deduction of contributions to employees' trusts only to the extent that such contributions represented liabilities accruing during the taxable year (i. e., for current services) and were reasonable in amount.

this basic principle by distorting the net income for the taxable year. What is more, it would open the door wide to easy tax avoidance by taxpayers whose business earnings fluctuate widely from year to year; tax liability for a high-income year could be reduced, or even extinguished, simply by carving out of the taxable income for that year a trust fund which is to be used to meet the expenses of future low-income years. This case presents a striking example of the use of the trust device for the purpose of minimizing tax liability. The trust was created on December 30 of a year in which the taxpayer was in approximately the 90% bracket for excess-profits tax purposes (R. 18), and taxpayer's president acknowledged that it was created in order to "provide in prosperous years for lean years" (R. 19). That tax saving was a dominant motivating factor is evident from the fact that, after the Commissioner disallowed the claimed deduction, the trust agreement was amended to provide that the trust fund be used to pay the resulting deficiency and the cost of litigating it (R. 10–15), and that practically the entire fund was in fact used to defray taxpayer's tax liability (R. 23).

2. Taxpayer relies chiefly (Pet. 5, Br. 12–13) upon an asserted conflict with *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C. A. 6th), which the District Court below deemed dispositive of this case as a matter of law (R. 25). But that case was remanded for further proceedings,

and an appeal by the Commissioner from the Tax Court's decision on the remand was pending at the time the petition for certiorari herein was filed. On this second appeal, recently decided (August 29, 1949, C. C. H., par. 9388), the Court of Appeals reversed the Tax Court's decision on the remand, and held that the Tax Court had misconstrued its prior opinion by considering itself required as a matter of law to allow the claimed deductions. It again remanded the case to the Tax Court, with directions to determine the reasonableness of the amounts claimed. In rejecting the taxpayer's contention that its prior opinion required allowance of the claimed deductions, the court stated that "As a matter of strict interpretation of our ruling, the taxpayer is incorrect in stating that we held the payments to be ordinary and necessary expenses and deductible in full."

The decision on the second appeal in the *Lincoln Electric* case dispels the conflict asserted by taxpayer. In that case some portions of the claimed deductions might by further proof be shown to constitute expenses of the taxable years in which they were claimed,[5] and accordingly remand of the case for determination of the reasonable amounts deductible in those years may have been appropriate. Here, on the other hand, no question of reasonableness of the amount de-

[5] Part of the payments involved in the *Lincoln Electric* case may have represented non-forfeitable benefits to employees in consideration of services already rendered.

ductible in the taxable year is reached, because no part of the amount could have represented an expense of that year; remand of the case to determine a reasonable amount allowable for that year would have been futile for, as is plain from the terms of the trust instrument itself, the instant fund was distributable in its entirety in consideration of future years' services. Any employee who did not remain in taxpayer's employ was to "forfeit" all right to share in the fund (R. 4), the trustees were enjoined from dispensing any of the fund during the first year of the trust (R. 6), and admittedly not a single dollar of it has yet vested in any employee (R. 17, 20). The court below recognized (R. 67) that an amount set aside in trust in one taxable year, bearing some "reasonable relation" to the operating expenses of that year, might qualify for deduction in that year. It properly refused, however, to assimilate such a situation to one where (as here) the fund is to be used solely to meet expenses yet to be incurred. *Roberts Filter Mfg. Co.* v. *Commissioner, supra.* Had this case come before the court which decided the *Lincoln Electric* case, there is no reason to suppose that a different result would have been reached.*

* After the preparation of this brief, the taxpayer in the *Lincoln Electric* case filed a petition for rehearing which the Court of Appeals for the Sixth Circuit has not yet acted upon. In the event that that court should grant the petition and substantially change its view of the case, the respondent may wish to reexamine its position in the instant case.

3. The importance which taxpayer ascribes to this case (Br. 13–14) has been minimized by amendments to Code Section 23 (p) and corollary Section 165 enacted by Section 162 of the Revenue Act of 1942, c. 619, 56 Stat. 798, applicable to taxable years after 1941. By these amendments Congress has dealt comprehensively with the deductibility by employers of payments to employees' trusts and under other deferred compensation plans. Section 23 (p) as amended provides that such payments to be deductible must satisfy the particular conditions there prescribed (in addition to the overall requirements of Section 23 (a)), and limits the amount deductible in any one taxable year.[1] The 1942 amendments

[1] The opening portion of Section 23 (p) as amended provides:

"(p) *Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan.*—

"(1) *General rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) [of Section 23] but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent: * * *"

Subparagraph (D) provides that contributions under plans not embraced by the preceding subparagraphs (which cover pension, retirement, stock bonus, and profit-sharing plans) are deductible only if the employees' rights "are nonforfeitable at the time the contribution or compensation is paid."

were designed to "safeguard the public against the use of the pension plan as a tax-avoidance device," and to treat "all methods of providing deferred compensation for employees" on a similar basis. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 51 (1942–2 Cum. Bull. 372, 413). See also *Roberts Filter Mfg. Co.* v. *Commissioner, supra;* Section 29.93 (p)–1 of Treasury Regulations 111 under the Internal Revenue Code.

CONCLUSION

The decision below is correct, and there is no conflict. The petition for certiorari should be denied.

Respectfully submitted.

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SEPTEMBER, 1949.

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(p) *Pension Trusts.*—

(1) *General rule.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust

during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

* * * * *

(3) *Exemption of trusts under section 165.*—The provisions of paragraphs (1) and (2) of this subsection shall be subject to the qualification that the deduction under either paragraph shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer ending within or with a taxable year of the trust with respect to which the trust is exempt from tax under section 165.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * *

(26 U. S. C. 1946 ed., Sec. 24.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.21–1. *Meaning of net income.*—

* * * * *

(c) Net income, meaning gross income less statutory deductions. The statutory

deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income. (See sections 23 and 24.)

* * * * *

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